D. DEVELOPMENTS IN THE SOCIAL CLUB AREA (IRC 501(c)(7))

1. Introduction

The purpose of this section is to provide an update in the social club area, IRC 501(c)(7). The 1980 (page 83), 1982 (page 41), and 1984 (page 118) CPE texts contain sections on social clubs.

2. Reciprocal Income of Social Clubs

Revenue Procedure 64-36 provided guidelines concerning the effect on the exempt status of a social club of nonmember use of club facilities and services for the period prior to July 1, 1971. (It was superseded by Rev. Proc. 71-17). Rev. Proc. 64-36 stated that the term "guests" includes, among other things, visiting members of exempt clubs of like nature, such as country clubs or yacht clubs, who use club facilities under reciprocal arrangements.

IRC 512(a)(3) was added to the Code by the Tax Reform Act of 1969 and provided special rules for determining the unrelated business taxable income of organizations exempt under sections 501(c)(7) or (9). Rules for 501(c)(17) and (20) organizations were added to IRC 512(a)(3) by the Deficit Reduction Act of 1984, P.L. 98-368. In general, IRC 512(a)(3) subjects all the income of an exempt social club to the unrelated business income tax except "exempt function income." IRC 512(a)(3)(B) defines exempt function income as:

> The gross income from dues, fees, charges or similar amounts paid by members of the organization as consideration for providing such members or their dependents or guests goods, facilities, or services in furtherance of the purposes constituting the basis for the exemption of the organization to which such income is paid.

Proposed regulations with respect to IRC 512(a)(3) were published in the Federal Register on May 13, 1971. The proposed regulations do not specifically state whether fees paid pursuant to a reciprocal arrangement by visiting members of another social club should be considered exempt function income. Proposed section 1.512(a)-3(c)(2)(ii), however, contains the broad statement that gross income from members does not include any amount paid to an organization by any person who is not a member even though paid for providing goods, facilities, or services. The proposed regulations, however, have not been finalized.

The proposed regulations were published simultaneously with Rev. Proc. 71-17, 1971-1 C.B. 683, superseding Rev. Proc. 64-36. Rev. Proc. 71-17 adopted many, but not all, of the principles enunciated in Rev. Proc. 64-36. Thus, for example, Rev. Proc. 71-17 defines general public for purposes of IRC 501(c)(7) and 512(a)(3) as persons other than members of a club or their dependents and guests. It makes no mention of visitors who are members of other clubs. While this silence has sometimes been interpreted to be deliberate, thus intending to withdraw the exception for visitors under reciprocal arrangements, it has also been conjectured that Rev. Proc. 71-17 did not address the issue simply because at the time of its publication this issue had not been resolved.

In either event, the issue of whether the silence of Rev. Proc. 71-17 effectively revokes Rev. Proc. 64-36's interpretation is rendered moot by Rev. Rul. 79-145, 1979-1 C.B. 360. Although it interprets the application of IRC 4421 to a wagering pool conducted by a social club exempt under IRC 501(c)(7), Rev. Rul. 79-145 applies the principles of Rev. Proc. 71-17 to IRC 4421.

Rev. Rul. 79-145 states:

> A guest of a nonprofit social club is an individual who is a guest of a member of the club and who ordinarily does not reimburse the member for the guest's expenses. On the other hand, amounts paid to a social club by visiting members of another social club are amounts paid by nonmembers, even though both clubs are of like nature and the amounts paid are for goods, facilities, or services provided by such social club under a reciprocal arrangement with such other social club.
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> Accordingly, in this case, the members of the other social clubs that attend the calcutta are not guests of the members of the host club, but are members of the general public within the meaning of Rev. Proc. 71-17.

Thus, the Service's current position is to treat income derived by a social club pursuant to a reciprocal agreement with a social club of like nature as income from nonmembers. Consequently, this income is potentially subject to tax and must be included within the 15% nonmember income gross receipts test and 35% nonmember income and investment income gross receipts test.

It has been brought to the attention of the National Office that this treatment of reciprocal income may have an effect on the "facilities usage method" of allocating fixed and operational expenses for purposes of the unrelated business income tax. (See Package 990-5, Big Divot Country Club, Inc. and IRM 7(10)69-71). It has been stated that, generally, the amounts received from reciprocal arrangements from services provided are small, but the volume of activity could be high. For example, receipts from reciprocal arrangements could be derived on a large number of days the club is open. This would increase the days of nonmember patronage used in the facilities usage method and correspondingly increase the weighted factors.

While this may occur to some extent, reciprocal income should not cause the weighted factors to change dramatically because sales to nonmembers on days of nonmember patronage are divided by total sales to members and nonmembers on days of nonmember use as one step in the computation. This tends to compensate for the increase in days of nonmember use.

3. Revenue Ruling 81-69 and the Decision in Cleveland Athletic Club

The 1984 CPE text contained an extensive discussion of Rev. Rul. 81-69, 1981 C.B. 351.

To summarize that section, Rev. Rul. 81-69 disallows the deduction of a portion of a social club's bar and recreational expenses allocable to nonmembers to the extent such expenses exceed nonmembership gross income from the same source. The ruling prohibits a club from offsetting such a nonmembership loss against net investment income for purposes of computing net unrelated business taxable income under IRC 512(a)(3). The ruling's rationale is that prices insufficient to cover costs, on a continuing basis, demonstrate that the bar and restaurant activity with nonmembers is not profit motivated under IRC 162. The ruling concludes that, absent such a profit motive, no trade or business exists, so that such expenses in excess of gross income are not trade or business expenses deductible under IRC 162, and are not available to affect investment income otherwise taxable under IRC 512(a)(3).

The 1984 CPE section went on to state that a determination of whether an activity is considered to be a trade or business is necessary for the purpose of determining whether expense deductions relating to a particular activity are allowable under IRC 162 or 212. An activity lacking a profit motivation does not constitute a trade or business, but a consistent series of losses is just one factor to

look at in determining whether a profit motivation exists. All the facts and circumstances should be taken into account.

Any doubts about the validity of Rev. Rul. 81-69 should have been allayed by the recent decision in Cleveland Athletic Club v. U.S., 588 F. Supp. 1305 (N.D. Ohio) 7-19-84. In that case, the Club's sales of food and beverages to nonmembers during 1975, 1976, 1977, and 1978 were sufficient to produce a gross profit; however, upon deduction of allocable overhead and fixed expenses, a net loss resulted. The Club offset its net losses on food and beverage sales to nonmembers against its investment income. Since the losses exceeded the taxable net investment income, the Club thereby eliminated all of its taxable income.

The Service, applying Rev. Rul. 81-69, did not permit the offset and issued a notice of deficiency. The Club paid the tax with interest and filed for a refund. The Club maintained that a profit motive is not a proper basis upon which to determine the deductibility of unrelated business losses incurred by an exempt social club and, alternatively, that the club did have a profit motive in the operation of its nonmember food and beverage sales. The Service responded by stating that a deduction of this type must be allowable under IRC 162, which governs ordinary and necessary expenses in carrying on a trade or business, and that since the Club had failed to meet this standard, the claimed deductions should not be allowed.

The Club argued that there was a distinction between IRC 512(a)(3) and 512(a)(1) - the absence of the phrase "trade or business" in the former - which absence, it claimed, established that gross income and deductions need not be derived from the conduct of a trade or business to be included in computing unrelated business taxable income under IRC 512(a)(3).

The court noted that IRC 512(a)(3) requires that for an expense to be deductible it must meet two requirements. First, the deduction must be directly connected with the production of gross income; and second, it must be a deduction allowed by this chapter. Both parties agreed that the deductions were directly connected with the production of gross income. The court stated that the phrase "allowed by this chapter" could only be read to refer to Chapter One of the Code and IRC 162 is Chapter One's general rule for allowance of trade or business deductions. Thus, the expenses claimed by the Club were deductible only if they were allowable under IRC 162.

IRC 162(a) provides that there shall be allowed as a deduction all ordinary and necessary expenses paid or incurred during the taxable year in carrying on any

trade or business. Whether activities amount to carrying on a "trade or business" within the statute is largely a matter of degree, and depends upon the facts in each case.

Among the factors used to determine whether a taxpayer is engaged in carrying on a "trade or business" is the presence or absence of a profit motive and business-like policies similar to those customarily evidenced by the taxpayer in other business activities. The Club conceded that to qualify as a "trade or business" under IRC 162, the activity must be "profit motivated".

The Club argued, in the alternative, that if the Code makes profit motive a prerequisite for the claimed deductions, the Club did in fact conduct its nonmember food and beverage sales with such a motive. To support this claim, the Club stated that its food and beverage sales generated enough revenue to offset more than $233,000 of the overhead and fixed expenses which Club members would otherwise have had to pay. The Club also claimed that the meals and drinks were priced competitively with other restaurants in the area.

The Club had the burden of proof to establish that its intent and purpose in the nonmember food and beverage sales was to make a profit. In determining whether such intent is present, the Service has promulgated (see Pub. 535, Business Expenses) the following guidelines: (1) the manner in which the activity was conducted; (2) the expertise of the taxpayer or of his advisors; (3) the time and effort expended on the activity; (4) the expectation of asset appreciation; (5) the success of the taxpayer in similar or dissimilar activities; (6) the history of income or loss of the activity; (7) the amount of profits, if any, that are earned; (8) the financial status of the taxpayer; and (9) the presence of elements of personal pleasure or recreation.

Using the above guidelines, the court held that the facts supported the Service's view that making a profit was not the primary objective of the Club's food and beverage sales to nonmembers. The facts indicated that although it was run in an efficient manner, and in an attempt to maximize earnings, the main objective of the food and beverage business was to defer some of the fixed or overhead costs which otherwise would have to be paid by the Club's members. Throughout the years in question, earnings from the food and beverage business never did exceed the overhead and fixed expenses, resulting in consistent net losses. Therefore, although the Club initiated the food and beverage program to lessen the financial burden on its members, it had not adequately established its intent that the program earn a profit.

We anticipate an appeal in the Cleveland Athletic Club case and there are at least two other cases concerning this issue currently pending in the Tax Court. However, we believe that this decision clearly upholds the validity of Rev. Rul. 81-69, and a number of Private Letter Rulings issued in this area (See PLR 8435099).